DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 06-0411
Adjusted Gross Income Tax
For the Years 2003, 2004, 2005

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ISSUE

I. **Disallowance of Royalty Expenses** – Adjusted Gross Income Tax**.**

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1(b); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, , 63 S.Ct. 1132 (1943); *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer protests the Department of Revenue's decision that taxpayer's expense deductions for royalty fees paid to a related entity should be disallowed.

STATEMENT OF FACTS

Taxpayer is a department store retailer based in Washington with one Indiana location. The Department of Revenue (Department) conducted an audit of Taxpayer. The Department concluded that claimed royalty expenses should be disallowed. Taxpayer disagreed with the decision and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer, represented by three of its employees, explained the basis for its protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. **Disallowance of Royalty Expenses** – Adjusted Gross Income Tax**.**

DISCUSSION

During the tax years at issue, Taxpayer paid royalty fees to a related entity located in Colorado. The amount of royalties was calculated at three-and-one-half (3.5) percent of Taxpayer's sales. Taxpayer paid the royalty fees in exchange for the right to employ certain trademarks and tradenames (generally referred to as trademarks) that are held within Taxpayer's group of companies. Taxpayer deducted those royalty fees on their Indiana tax returns. The fees ranged between $197 million and $215 million each year.

The audit disallowed the claimed expenses because "the deduction for royalty payments on the use of trademarks distorts the taxpayer's true income derived from sources within Indiana." In support of that position the audit report cited to IC § 6-3-2-2(l)(4), which states:

> (l) *If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable*:
> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) *the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income*.

(*Emphasis added*).

The Department's reliance on IC § 6-3-2-2(l)(4) is mistaken because this part of the statute relates to replacing the apportionment methodology with *another methodology* in order to fairly reflect the income Taxpayer earned from Indiana sources. In this instance the audit disallowed an expense deduction but left in place the standard allocation and apportionment methodology.

IC § 6-3-2-2(m) provides the Department with the authority to reallocate the royalty fee expense deduction back to income Taxpayer derived from its sales in Indiana, in order to fairly reflect and report that income in Indiana. IC § 6-3-2-2(m) states:

> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The trademark holding company is a wholly-owned subsidiary of Taxpayer, so clearly, the holding company is controlled by the same interests. The net income to Taxpayer from its sales in Indiana is clearly reduced by the business expense deduction Taxpayer takes for the royalty fees it pays to its wholly-owned trademark subsidiary. The question, then, is whether or not these deductions were taken as ordinary and necessary business expenses and whether the deduction fairly or unfairly reduces Taxpayer's taxable income in Indiana. This question was the substance of the discussion with Taxpayer at the hearing. The hearing was held open to allow Taxpayer the time it needed to properly document its position.

It is well settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves

a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." *Id*. at 439. The state courts have been consistent in applying this "business purpose." *See Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer cited its compliance with IRC § 482 which, it argues, requires arm's length terms for activities between legal entities. (IC § 6-3-2-2(m) is Indiana's equivalent of IRC § 482). Taxpayer further argues, in its protest letter dated November 3, 2006, that their trademarks "are fairly valued and the inter-company royalty expense between [Taxpayer] and [its related entity] is paid at a reasonable rate consistent with common business practices." Subsequent to the hearing, Taxpayer provided a "Mark Analysis," dated October 31, 1998, to substantiate the valuation of their trademarks and the royalty rate charged. These documents appear to generally support arm's length valuation and rate-setting by Taxpayer. However, the arm's length nature of these transactions is but one element of the analysis. In order to qualify the necessary and ordinary business expense, this inter-company transaction must be viewed within the larger set of inter-company activities.

At the hearing, the Department made clear that it was interested in understanding the economic realty and business purpose of the trademark transfer and the business relationship between Taxpayer and its trademark holding company. The Department indicated that it was particularly interested in inter-company transactions that potentially flowed money back to Taxpayer from its trademark holding company – for example, loan, dividend, and profit-sharing activities. At the hearing, Taxpayer indicated that the trademark subsidiary did indeed loan some funds back to Taxpayer. The Department requested documentation of these loans and any other documentation that would describe the inter-company activities. Subsequent to the hearing, in a letter dated September 14, 2007, Taxpayer provided the following by way of documenting the inter-company loan activity:

> The interest paid by [Taxpayer] or affiliates to [trademark subsidiary] when borrowing funds is calculated using a market commercial rate, Falcon A1P1 commercial paper rate + 15 basis points for dealer fee. A summary of pertinent [trademark subsidiary] activity during the audit period is as follows:

	Interest Income	Notes receivable balance
1/31/03	$6,881,277	$481,818,137
1/31/04	$7,294,457	$622,285,000
1/31/05	$11,974,282	$777,010,000

Taxpayer's documentation does not sufficiently describe the loans it received from its trademark subsidiary. The information above raises more questions than it answers, including the possibility that Taxpayer's royalty fee expenses are being returned to Taxpayer, at least in part, through loans at seemingly low interest rates if one simply derives interest rates from the above interest income relative to the "notes receivable" balance. This, of course, would not necessarily be an accurate calculation, but that is precisely the point: Taxpayer has not sufficiently substantiated the loan activity between it and its trademark subsidiary as necessary and ordinary business expenses thus fairly reducing its Indiana taxable income.

As noted in IC § 6-8.1-5-1(b), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In this particular case, Taxpayer has not met its statutory burden of reasonably demonstrating that the Department's decision disallowing the royalty expenses is incorrect.

FINDING

Taxpayer is respectfully denied.

LS/WL/DK – November 27, 2007